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Supreme Court of the United States

October Term, 1933

MANHATTAN PROPERTIES, INC,
Petitioners
against
IRVING TRUST COMPANY, as Trustee in Bankruptcy of Oliver A. Olson Co., Inc.
Respondent
No. 505

SAMUEL R. BROWN, ALMIRA B. MILLARD, ALFRED MILLARD and HUGH MILLARD
Petitioners
against
IRVING TRUST COMPANY, as Trustee in Bankruptcy of United Cigar Stores Company of America, a New Jersey Corporation
Respondent
No. 506

BRIEF FOR CREDITORS ADVISORY COMMITTEE OF McCRORY STORES CORPORATION AND CREDITORS COMMITTEE OF McLELLAN STORES COMPANY, AS *AMICI CURIAE*

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BRIEF FOR CREDITORS ADVISORY COMMITTEE OF McCRORY STORES CORPORATION AND CREDITORS COMMITTEE OF McLELLAN STORES COMPANY, AS *AMICI CURIAE*

This brief is submitted on behalf of the Creditors Advisory Committee of McCrory Stores Corporation and the Creditors Committee of McLellan Stores Company.

The brief is designed to emphasize certain practical considerations inherent in the interest which merchandise creditors have in the important question now before the Court. No attempt is made to cover the general themes argued at length in other briefs. We venture merely to bring to the Court's attention the practical consequences as regards mercantile credit, the entire credit system and the claims of merchandise creditors in bankruptcy if the contentions now advanced by the landlords are sustained.

These practical considerations may be readily illustrated:

In the Blyn Shoe insolvency proceeding the merchandise and loan creditors aggregate approximately $500,000, whereas the claims filed for breach of leases aggregate approximately $2,900,000.

In the McLellan Stores bankruptcy the general claims for merchandise, money loaned and expense items aggregate less than $2,000,000, while the claims filed for future terms of leases aggregate $3,900,000, with many of the landlords not filing for the future terms in view of the uniform rulings of the bankruptcy courts that such claims were not provable.

In the McCrory Stores bankruptcy the merchandise and loan creditors aggregate approximately $9,000,000, whereas the claims of landlords for future terms are something like $43,000,000.

Illustrations such as these demonstrate that if the claims of landlords for future rents or for the supposed value of future terms were held provable in bankruptcy, the entire credit system would have to be revised; financial statements would have to include contingent and fluctuat-

ing liabilities which now never appear therein; and merchants and lenders would be obliged to insist upon absolute security lest some landlord or landlords might absorb practically the entire estate in the event of insolvency.

The entire credit structure and the approval and passing of credits rest upon the assumption that contingent claims for future rent relate to something which this Court has said "issues from the land (and) is not due until the rent day" (*Wm. Filene's Sons Co.* v. *Weed*, 245 U. S. 597, 601), and is therefore not to be regarded as a liability provable in bankruptcy.

No person giving credit could with certainty determine from a financial statement the ability of the debtor to pay, if he were obliged to take into consideration the possibility of claims for damages arising from leases. Any such person would be compelled to stop and ascertain the conditions and circumstances of every lease of the debtor, obtain expert opinion as to the possible extent of the liability represented by it in the event of the debtor's insolvency, and gamble upon all the fluctuating values of real estate over a long period of time.

Either the long term lease would disappear from business life because no concern could obtain credit if it had potential provable liabilities existing over long periods of time, or else the free circulation of mercantile credit would be checked, and general business would be obliged to resort to a much greater use of cash in making purchases or to a much greater use of collateral security in support of credit.

Economists are generally agreed that a freer use of commercial credit is essential to lifting this country out of the disastrous consequences of the present depression. But the contentions of the landlords would have the very

opposite effect upon credit, and to that extent would make the task of effecting national recovery appreciably more difficult. In other words, the contentions of the landlords are economically as well as legally wrong, and they do not harmonize with sound public policy.

Furthermore, the landlords start with one big and very valuable preference and advantage over general merchandise creditors, and to that preference a second should not be added. The landlord always gets his property back; the merchandise creditor never does. The landlord at all times has the security of his own property, whereas the general merchandise creditor has no security. In the event of the insolvency of the tenant, the landlord is free to re-rent the property for any figure which the future real estate market over a period of years may make possible, and he is free to sell the property outright at any time and seek recoupment from the proceeds. The merchandise creditor cannot expunge or mitigate his loss out of the property which he has sold, and certainly he cannot recover and resell it.

The usual lease is drawn with far more careful consideration for the rights of the landlord than for the rights of the tenant. The landlord seeks to bolster his right to recover the property by every conceivable device and language; and in bankruptcy the usual claims presented by landlords are claims based upon covenants which do not contemplate ordinary current financial obligations but seek to secure the landlord out of the assets of the bankrupt estate at the expense of the general creditors. Nearly every important lease contains an agreement, exacted by the landlord, which tends to defeat the beneficent design of the Bankruptcy Act to bring about an equitable

distribution of the bankrupt estates among creditors holding just demands based upon adequate considerations. In all provisions in leases which seek to govern the situation after bankruptcy, the tenant and the landlord have both contracted with the Bankruptcy Act in mind. The tenant is in the position of really caring nothing about the rights which he gives the landlord after bankruptcy has divested him of control and enjoyment of the property; and neither he nor the landlord has much interest in the dividends going to general creditors.

In *Kothe* v. *Taylor Trust*, 280 U. S. 224, this Court pointed out the importance of the very considerations which we are now urging. There, in a lease for two years the lessee had agreed that the mere filing of a petition in bankruptcy against him should be deemed a breach, and that thereupon *ipso facto* the lease should terminate and the lessor become entitled to re-enter and also to recover damages equal to the full amount of the rent reserved for the remainder of the term. The lessee became bankrupt, and the lessor claimed $5,000, equal to fifteen months' rent. This Court held that the claim could not be enforced against the trustee in bankruptcy since the provision in the lease must be regarded as one for a penalty apparently designed to insure to the lessor preferential treatment in the event of the lessee's bankruptcy. At page 226 this Court said:

> "The parties were consciously undertaking to contract for payment to be made out of the assets of a bankrupt estate—not for something which the lessee personally would be required to discharge."

And on page 227 this Court said:

> "The broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate among creditors holding just demands based upon adequate consideration. Any agreement which tends to defeat that beneficent design must be regarded with disfavor. Considering the time which the lease here involved had to run, nothing else appearing, it seems plain enough that the real design of the challenged provision was to insure to the lessor preferential treatment in the event of bankruptcy. The record discloses no circumstance sufficient to support a contrary view. If the term were much shorter, or there were facts tending to disclose a proper purpose, the argument in favor of the lessor would be more persuasive."

Thus, as this Court has pointed out, the landlord who contracts for rights after bankruptcy knows that he is contracting for a distributive share in assets as against creditors who, as a rule, are in a different class altogether, are not getting their property back, and in the nature of things cannot stipulate for special consideration in the event of bankruptcy.

In this *Kothe* case this Court declared that the argument of the landlord might be much more persuasive if the "term (of the lease) were much shorter." The term in that case was only two years. What then will this Court have to say of situations where the terms of the leases run from ten years to ninety-nine years?

Furthermore, general merchandise creditors whose goods have created the bankrupt's business take the risks of the commercial vicissitudes and cycles of the immediate future, whereas the contingent claims of landlords

under long term leases would value the whole term on a fixed and absolute basis. The landlord's contention, therefore, presents the anomaly that the longer the lease the less likelihood of ultimate loss to the landlord through re-entry and re-letting, but at the same time the greater proportion of the bankrupt estate which would be absorbed by the landlord. If, in such case, the landlord's claim for the future term is provable, he may collect his dividends and at the same time actually realize in the future out of the property more than enough to equal 100% of his claim; whereas the merchandise creditor can never have (to use colloquial language) any such "ace-in-the-hole." The landlord under a long term lease who recovers his property as the result of bankruptcy may recoup himself against the consequences of any temporary business depression, but the consequences of such business depression to the credit extended by the merchant or lender of money is final and irretrievable.

It can be justly said that our system of credit is based, and for many decades has been based, on the settled rules of law which the landlords now seek to change. Those rules of law have built themselves into the whole credit and commercial structure. As a result of their long acceptance, balance sheets never show liability for future rent, either as a fixed or contingent liability; banks lend money and merchants supply merchandise on the strength of balance sheets which omit such items; credit managers do not inquire into any such remote sources of liability; and the universal assumptions of the business world have been that in the event of insolvency the general creditors could look to the tangible assets and the landlord could look to his own recovered property. During the present depression many important businesses have been saved by

temporary advances of credit made upon these very assumptions; and the landlords have had the benefit thereof, for their tenant has thereby been tided over the momentary exigency. Had it been believed that some contingent claim of the landlord on a long term lease could be provable in bankruptcy against the assets created by the credit extended, that necessary and life-saving accommodation would never have been extended at all, for the consequence might then be that the landlord would get his property back and at the same time absorb all the avails of such credit without any liability connected with it.

We respectfully submit that these commercial practices and assumptions based upon rules of law of long standing should not be upset except for the most impelling reasons. To suddenly change the "rules of the game" in the midst of the present depression would almost be the equivalent of defrauding, and would certainly be the equivalent of destroying, large numbers of merchandise creditors and lenders of money. If it is proper that the rules be changed at all, the changes should be made solely by Congress and then only as to future cases.

This Court, in *Maynard* v. *Elliott,* 283 U. S. 273, when passing upon the right of a holder of a note to prove against the endorser, observed that a certain rule of law had been adopted by the 2nd, 3rd and 9th Circuits and also by the District Courts generally, and then said:

> "Only compelling language in a statute, itself, would warrant the rejection of a construction so long and so generally accepted, especially where overturning the established practice would have such far-reaching consequences as in the present instance."

The rule that the future term of a lease, whether valued in terms of rent or damages, is not provable in bankruptcy, has been held as follows:

First Circuit— *Slocum* v. *Solliday*, 183 Fed. 410;
McDonnell v. *Woods*, 298 Fed. 434;

Second Circuit— *In re Roth & Appel*, 181 Fed. 667;
In re Barnett, 12 Fed. (2) 73;

Fifth Circuit— *Atkins* v. *Wilcox*, 105 Fed. 595;
Trust Co. v. *Whitehall Holding Co.*, 53 Fed. (2) 635;
Orr v. *Neilly*, 67 Fed. (2) 423;

Sixth Circuit— *Wells* v. *23 St. Realty Co.*, 12 Fed. (2) 237;

Seventh Circuit—*In re National Credit Clothing Co.*, 66 Fed. (2) 371;

Eighth Circuit— *Watson* v. *Merrill*, 136 Fed. 359;
Barton v. *Western Iowa Co.*, 9 Fed. (2) 488;

Ninth Circuit— *Coleman* v. *Withoft*, 195 Fed. 250.

The same doctrine is followed in New York under the Assignment for the Benefit of Creditors Act.

Matter of Havenor, 144 N. Y. 271;
Kottler v. *The Bargain House*, 242 N. Y. 28.

Countless District Courts have held that the future term of a lease is not provable, whether presented as damages or rent.

One further consideration presents itself. The landlords have the almost uniform practice of incorporating in the lease a clause to the effect that on the filing of a petition in bankruptcy, the lease may be terminated and the landlord may repossess himself of the premises. This clause has effectively been used by landlords when lease values were rising to take over their property and deprive the estate of any of the benefits of enhancement. On the other hand, when the value of the leasehold decreases, the landlord seeks to assert damages and share with the general creditors. In colloquial language, the landlords win on either "heads or tails," and the creditors lose.

This Court has already emphasized the distinction between contracts governing realty and contracts governing personalty. The doctrine of anticipatory breach has no application to real estate since the law of real estate became fixed long prior to the rise of that doctrine. Neither the failure to pay rent nor the filing of a petition in bankruptcy is in itself and at common law an anticipatory breach of the lease. As stated by this Court in *Wm. Filene's Sons Co.* v. *Weed*, 245 U. S. 597, 601:

> "Rent issues from the land, is not due until the rent day, and is due in respect of the enjoyment of the premises let."

And as stated by this Court in *Gardiner* v. *Butler & Co.*, 245 U. S. 603, 605:

> "The law as to leases is not a matter of logic *in vacuo;* it is a matter of history that has not forgotten Lord Coke."

See also:

Wells v. *23 St. Realty Co.*, 12 Fed. (2) 237;
In re Service Appliance Co., 39 Fed. (2) 632.

Respectfully submitted,

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